DR. KURT RICHEBÄCHER

Frankfurt
GERMANY

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"Sound theory of the business cycle is a prerequisite to accurate forecasting alike in the realm of business and the domain of economics."

Phillips, McManus, Nelson, Banking and the Business Cycle, 1937
Reprint 1972, Arno Press & The New York Times, New York, p. 147.

HIGHLIGHTS

We are pondering whether or not the stage is being set for something much bigger than just a slowdown in the U.S. economy. What causes our concern is the growing tension between shrinking overall liquidity and the heightening liquidity risks of overspeculated financial markets.

Overheated and overleveraged markets definitely pose the greatest threat to the U.S. and world economy, involving ever-increasing liquidity risks for banks, brokers, and investors.

In the entire postwar period, there is no precedent for the kind of financial market situation that we are witnessing now. The last time conditions were analogous to today was back in 1929-30. We draw some parallels.

As we expected, the U.S. economy is again losing momentum. The peak of its cyclical thrust is very likely already over. The only remaining questions are the implications for the financial markets and the potential size of the economic setback.

In hindsight, the budget inflation of 1991-92, the biggest ever experienced in the United States, by force of its sheer magnitude and resulting creation of money and purchasing power, was bound to have significant demand effects. For the U.S. economy, there's now little left for an encore.

Given the unprecedented broad money weakness, what's beginning to unfold in the U.S. deserves to be called deflation. It may seem confusing to the untrained eye for the time being because buoyant financial markets are giving a deceptive appearance of excess liquidity.

What we see is a general scramble for liquidity within a shrinking pool of liquidity overall. Deflation in real capital assets and the real economy may well co-exist for a while with inflation in the financial sphere. Needless to say, they can't coincide forever.

What about the rising gold price? The dollar crisis we envision will lead to a flight into gold and other foreign currencies. However, the coming asset price deflation will not be positive for gold. There may well be a tug-of-war between the two influences.

Generally, securities markets are becoming ever more treacherous. Capital conservation and liquidity should be the uppermost priorities. There's little else to do other than to continue seeking safe harbour in short-term money investments and the bonds of the strong-currency countries — Germany, the Netherlands, Switzerland as well as Austria and Belgium.

THE APPROACHING DOLLAR CRISIS

Generally, there is a growing optimism that the worst is over for the world economy as a whole. According to the international consensus, the U.S. and U.K. economies, not to mention some of the smaller lights, are believed to be safely on the path of sustained growth. Any further optimism is reserved for Japan, where a large fiscal stimulus package, recently announced, has yet to take effect. Europe, though, is not expected to stabilize and recover until next year.

As the major supra-national forecasting organizations would have it, world growth — after bottoming out this year — is supposed to return to a more normal growth rate of 2.5% to 3.0% in 1994. These growth forecasts hinge on two critical assumptions: a continued and strong U.S. recovery, and prompt stimulative results from the recent and prospective interest rate cuts in Europe. Unfortunately, we have little faith in either of these forecasts. Realistically, it's much more likely that the world will see severe disappointments.

THE U.S. ECONOMY: A FLY IN THE OINTMENT

The performance of the U.S. economy is most troublesome. After having produced a sub-par recovery all along, momentum slowed sharply in the first quarter of 1993. Yet, market opinion, although completely taken by surprise, is dismissing this relapse as an aberration mainly due to bad weather and statistical distortions. The sudden downturn is just too contrary to popular expectations for it to be readily believed.

As our past readers know, we have expected an economic slowdown. The more we studied the current U.S. recovery, the surer we were that it was grossly deficient in the normal, crucial business-cycle dynamics, such as investment and private credit growth. This sub-par recovery was, in short, driven by two temporary substitutes which now are rapidly losing their thrust — an enormous budget inflation and a fresh bout of asset price inflation which this time is focused on stocks and bonds.

GROWTH BY MONEY MAGIC

Budget inflation played a significant role by stimulating a recovery in two ways. The first was a doubling of the federal budget deficit from a two-year total of $300 billion in 1989-90 to $600 billion in 1991-92. The second was an increasing monetization of the budget deficit through a doubling in the net purchases of government bonds by the Federal Reserve and the banks. These purchases rose from $113 billion to $273 billion in these two periods. Monetization occurs when the central bank and the banking system buy government debt. The effect of these purchases is to create deposits (money) and force up bond prices. Half of the total budget deficit was monetized in this way during 1991-92.

It is important to understand this money creation process. When a bank buys a government bond, it credits the government with a corresponding amount in deposits . . . essentially new deposits. The government then writes checks to pay for goods, services or transfer payment against these deposits. The recipients of these checks then, deposit them in their own bank. These deposits, now to the credit of mainly businesses and private households, are in turn available for their new spending.

In hindsight, what we see is the most rampant budget inflation ever experienced in the United States. By force of its sheer magnitude, the resulting creation of money and purchasing power, much of it going into surging transfer payments, was bound to have significant demand effects. The salient fact,

ominously, is that it failed to stimulate a self-sustaining and self-reinforcing economic recovery. It failed to "*prime the pump*", as they used to say in the 1930s.

Closely associated with this rampant budget inflation was a coincident rampant inflation of financial asset prices. Next to the Treasury itself, the financial markets and holders of financial assets proved to be the big beneficiaries of the Federal Reserve's aggressive action. Over the last two years, stocks are up an average of 65%, bonds 30%, and junk bonds 38%. In short, the chief impact of the monetary easing was an enormous inflation of stock and bond prices.

This new wave of asset price inflation has contributed huge wealth effects to the owners of financial securities. Without any question, this has been an important support to consumer spending and a detriment to private savings.

But, isn't this wonderful? What could be wrong with this? In short, there are two characteristics of this supposedly perpetual prosperity machine that leads to a dangerous trap: first, there are limits to how far budget and asset price inflation can be stoked; and second, it makes the U.S. economy and its financial system increasingly vulnerable, as banks, brokers and investors are incurring ever greater and greater liquidity risks. A speculative bubble in the securities markets, once started, can only end one way: an uncontrollable bust. Once it bursts, given its huge size, the impact on the real economy will be severe.

FALSE LIQUIDITY

For the time being, the buoyant financial markets are giving a deceptive appearance of excess liquidity. There is a comforting slogan that the markets bullishness is "*liquidity-driven.*" Others even argue that mutual funds ought to be counted as a component of broad money, and in doing so, would reveal the true abundance of liquidity. According to many brokerage houses, the American public is sitting on a mountain of idle cash that has no other outlet than stocks or bonds, thus boosting their prices. In reality, what's at work here is excessive leverage, not excessive liquidity.

What all this shows is that most economists and analysts don't have the faintest idea of the true nature of the monetary processes currently impacting the U.S. economy and its financial markets. The consensus sees the U.S. economy in a healthy reliquefication process with businesses and consumers busily reducing their debt burdens and repairing their balance sheets. The reality is exactly the opposite — a general scramble for liquidity within a shrinking pool of liquidity overall. What else could the widespread corporate "downsizing," radical cost cutting, rampant labour-shedding, and the persistent weakness of business investment reflect other than a desperate scramble for liquidity and profitability?

What's apparently fooling most people about the true state of liquidity are the buoyant financial markets. For many, they are the self-evident proof of excess liquidity. They are wrong. This new speculative mania in U.S. stocks and bonds is occurring against the background of sharply shrinking overall liquidity. However, within this contracting aggregate, there is a stampede out of existing bank deposits into financial assets. Why? For several reasons: an income crisis as interest income collapses; the lure of apparently higher returns in stocks and bonds as short-term rates remain significantly below long-term rates; and the attraction of past gains. Even businesses are piling into financial assets as never before.

Single firms can improve their profitability and liquidity by cutting costs and expenditures. But while

this works at the singular level, it cannot increase liquidity overall. Any liquidity gains by one firm must work their way through as income and liquidity losses to others, whether individuals, governments or businesses. In fact, when such retrenchments become endemic, it becomes a depression.

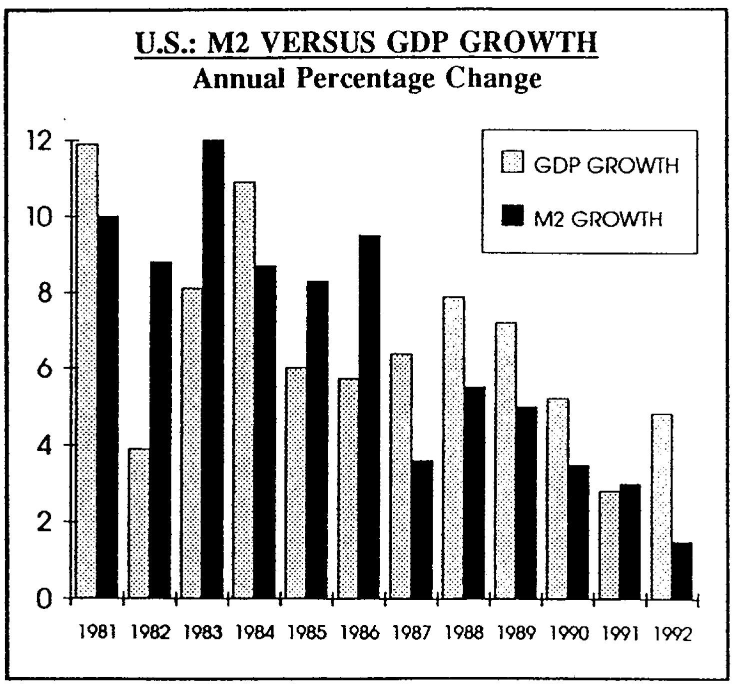
It's easy to determine whether or not overall liquidity is increasing or decreasing. One just has to look at the broad monetary aggregates — M2, M3 and M4 or L. If these measures of money grow faster than economic activity and inflation, as conventionally measured by nominal Gross Domestic Product (GDP), it indicates expanding overall liquidity. If the broad aggregates grow less than nominal GDP, it indicates contracting overall liquidity.

Reviewing the 1980s with this distinction in mind, the year 1986 stands out as a watershed. From 1982 to 1986, broad money consistently grew in excess of nominal GDP. During this period, M2 had a cumulative increase of 57% while GDP increased by a lesser 40%. It was a clear case of excessive money creation.

Ever since 1987, though, this relationship has gone into reverse. Increasingly, money growth is falling short of economic activity and inflation, generating a rapidly growing "liquidity gap." Cumulative M2 growth over this period to 1992 of only 24% compares with 39% nominal GDP growth. And this trend is getting worse, not better. During the last two years, broad money — in other words, overall liquidity — has been virtually stagnant, and lately is even shrinking.

DEFLATION AND THE NATURE OF INFLATION

We think what's happening is beginning to deserve the term deflation. This by no means contradicts our earlier assessment of rampant budget and financial asset price inflation. Deflation in real capital assets and the real economy can co-exist with inflation in the financial sphere for quite awhile. Needless to say, it can't go on forever. Sooner or later, one of the two will dominate. Either deflation, as manifested in shrinking overall liquidity, will hit the financial sector causing crashing asset prices, or financial inflation will spill over into the real economy.



The first thing to sort out is the definition of inflation. Among American economists, the traditional gauges are the price indexes, mainly the consumer price index (CPI). According to the old European view, inflation has always been considered to be a much broader phenomenon. In this view, the essence of inflation is not rising price indexes, but the overexpansion of credit relative to available savings. When this happens, economic distortions, speculative excesses, overindebtedness and trade and current account deficits are the inevitable result.

The key fundamental measure of inflationary forces, in other words, is credit inflation, not price inflation. The latter is a symptom, but not a necessary one. How a credit inflation impacts the economy and its price system, including the financial markets, depends entirely upon how the borrowed money is spent in the first place and how it works its way through the economy and the financial system. The credit inflation of the 1970s went largely into tangible assets, consumption, and goods and services, forcing up their prices. By contrast, the credit inflation of the 1980s primarily boosted U.S. asset prices — real estate, stocks and bonds — and the U.S. trade deficit.

All credit inflations, no matter their outlet, have one common ill-effect: distortions and dislocations in the demand and output structure of the real economy, typically taking the form of overconsumption and malinvestments. In this crucial structural respect, the asset price inflation that afflicted the Anglo-Saxon countries and Japan in the 1980s was far more destructive than the price inflation of the 1970s.

MONEY: DESTRUCTION GREATER THAN CREATION

Given the massive money creation through the heavy monetization of the budget deficit, the stagnating — lately even contracting — money supply is something of a puzzle. Where are the leaks? It leads us to make two connected observations which point to an uncomfortable conclusion: first, the large-scale monetization of the soaring budget deficit was necessary to prevent a much deeper recession and to foster the modest economic recovery; and second, budget deficits and bank purchases of bonds have their limits. Whenever these slow down, as they eventually must, the situation for the economy and the markets will become precarious.

What about the most recent liquidity trends? Isn't there at least a turn for the better? The answers are plain to see in the broad money aggregates — M2, M3 and M4. The fact is that they have never performed worse than over the past few months.

There are two popular overworked apologies for this protracted monetary sluggishness: that institutional changes have supposedly diminished the role of the banks in the credit system and that a massive portfolio shift by investors out of CDs and into mutual funds, stocks and bonds, involving some $200-$300 billion over the past two years, are the main causes.

But what this last apology overlooks is that this pattern of shifts in money and credit flows is nothing unusual. It's precisely what always happens in times of easy money and low interest rates. The technical term for this regular development is "disintermediation." Corporations rush to issue stocks and bonds, and investors rush to buy them either directly or through mutual funds. Yet, past recoveries were always associated with rapid growth in broad money.

No doubt about it, there is something unusual this time. It is a net reduction in bank debt. This has never happened before, especially not during a recovery period. It's true that when corporations issue stocks and bonds and use the proceeds to pay down bank debt, it extinguishes bank deposits (money) in line with the repaid credits (debt). But during past cyclical upturns, businesses always made heavy use of all available sources of finance, particularly the securities markets and the banks. Every single past recovery was therefore associated with a rapid broad money expansion which was driven by bank credit. What we see now is the exact opposite: weak bank credit implying a weak economy. That squares the circle.

At the bottom of this development are U.S. businesses that are retrenching. Their total net intake of new funds are at record lows, whereas their purchases of financial assets are at record highs. Like the banks, they may slowly become mutual funds for Treasury bonds and other securities.

MEASURING THE DEPTH OF A NEW DOWNTURN

It's important to recall that broad money growth is determined by bank credit growth by way of bank loans and bank investments. Broad money is really a proxy for bank credit. The following table compares broad money growth in past recoveries with that in the present. The statistics leave little room for debate. During the first two years of past recoveries, cumulative broad money growth (M2) averaged 23%. This time, it's been virtually zero. Clearly, the quantity of credit is at the root of the problem.

The low quantity of credit is only one reason why we doubt the staying power of the U.S. recovery. The poor quality of credit is a second reason. The effects of a credit expansion are not just a question of quantity; they are even more dependent on the purposes which the lending and borrowing activities serve. For example, during the weak credit expansion of 1991-92, fully 57% of new credit went into "soft" government credit, financing transfer payments and the like. The rest went largely into mortgages. "Hard" business credit for investment purposes has been nonexistent.

U.S.: PAST VERSUS PRESENT PATTERNS OF MONEY AND DEBT GROWTH
Cumulative, First 8 Quarters of Each Recovery

BEGIN	M1	M2	M3	TOTAL DEBT
Mar-61	5.1%	16.4%	18.1%	13.3%
Dec-70	15.3%	28.0%	30.9%	19.5%
Apr-75	13.4%	28.8%	23.6%	21.5%
Dec-82	16.0%	21.2%	21.5%	26.9%
Apr-91	22.8%	2.9%	-0.9%	12.7%
AVERAGE (1961-82)	12.4%	23.6%	23.5%	20.3%
SINCE 91	22.8%	2.9%	-0.9%	12.7%

What should we look for next? What and where are the big risks in this development? Presently, the major worry seems to be that too strong a recovery will fuel inflation in America. To start with, in our view, the perception of a strengthening recovery is utter nonsense. There is absolutely nothing in the data that supports this belief. For every strength, rare as that is lately, there are many more weak indicators.

By now, the overwhelming evidence is that the U.S. recovery has stalled. It was sick and fragile right from the start in any case. For us, the big questions that remain are the implications for the financial markets and the potential size of the economic setback.

The number one factor influencing the size of the downturn must be fiscal stimulus. It was the ballooning budget deficit financed by a massive monetization that mainly powered the modest recovery to begin with. If fiscal stimulus slows, there will be no domestic source of demand to take its place. And externally, the former strong support of exports is waning, too.

Can the budget deficit and its monetization continue to support the economy this and next year? Surely, the federal budget deficit will rise, but a lot less than over the last two years. As to its monetization, we wonder. Everything depends on the banks' willingness to raise their already high wager on the yield-curve game. We think they will slow their pace of government bond purchases. All this implies a drastic reduction in the fiscal stimulus.

Above all, we must take our chief clue from the protracted sluggishness of broad money and private credit. In the absence of strong private credit growth, a reduction in the fiscal stimulus would mean even weaker broad money growth. That can only spell a further economic weakening.

FINDING THE RISKS

As already pointed out, the markets can identify only one spoiler to their bullish party of low short-term interest rates and rising securities prices: accelerating inflation. For us, it's an established fact that the U.S. economy is more inflation-prone than ever. The proof is plain to see. Given the protracted sluggishness of GDP and money growth, the inflation rate ought to be 2% or less, rather than the present 4%. This heightened inflation-bias has its cause in the U.S. economy's abysmal savings and investment ratios. That means that the relatively high U.S. inflation rate is of a structural, not monetary, origin. If there were a really strong economic expansion, there's little doubt that U.S. inflation would soar.

But not to confuse the situation, the basic facts speak of the exact opposite presently: very weak money growth and weak GDP growth. While we don't wish to underestimate the inflation risk due to the structural inflation proneness of the U.S. economy, a renewed bout of serious cyclical inflation isn't likely. In that sense, inflation worries are misplaced. In our opinion, the real risk is being ignored. Most people grossly underestimate the enormous risks inherent in the inflated stock and bond market. These overheated and overleveraged markets definitely pose the greatest threat to the U.S. economy, involving ever-increasing liquidity risks for banks, brokers, and investors.

The bullishness reflected in the stock and bond market is largely the product of the steep U.S. yield curve — long-term rates being much higher than short-term rates. It's contributed to a money machine that's running amok. Over the last two years, incredibly, the Federal Reserve, banks and brokers bought $387 billion worth of bonds, financed by money creation. However, the thing to see is that all this money remains bottled up in the financial sphere whereas the real economy goes begging for liquidity.

These trends can't go on very much longer in such extremes. As soon as this money machine begins sputtering, the financial markets will immediately be in jeopardy. Any reversal can quickly deteriorate into an uncontrolled crisis. Even though most people may not fully understand this dangerous situation, the repeated market jitters certainly do reveal a general nervousness. These markets are vulnerable to an accident or some kind of catalyst for a meltdown.

One can think of various things that might burst the bubble. The most probable outcome is that over the course of this year there is a belated recognition that the U.S. economy is much weaker than expected, combined with disappointing business earnings.

A slump on Wall Street would undoubtedly rock the economy since the long bull market with its attendant big wealth effects greatly helped to sustain consumer demand. More importantly, the financial

market boom was crucial in creating and maintaining overall confidence. Any downturn, therefore, will act as a psychological catalyst.

In the entire postwar period, there is no precedent for the kind of financial situation that we are witnessing today. The last time conditions were analogous to the present was back in 1929-30.

PARALLELS TO THE 1920-30s

The 1920s, too, were a period of asset price inflation. Capital values rose out of proportion to capital assets, fuelled by credit inflation. Between 1921 and 1929, total bank deposits increased 55% whereas GDP only grew 41%. The greatest market excesses occurred in 1928-29 spurred on by the proliferation of investment trusts. However, business investment and construction and broad money stagnated. Instead, all economic growth was centred in private consumption. Still, according to economists who measured inflation exclusively by the price indexes, it was a "*New Era of Eternal Prosperity*" because consumer prices had been stable since 1922.

Two events overshadowed the following Depression. One was the successive banking crises, and the other was the stock market collapse. It became the consensus view among historians — led by Milton Friedman — that it was the bank failures and the associated money destruction that played the decisive role in driving the economy into depression. By comparison, the importance of the Wall Street collapse tends to be minimized.

In our view, the rise and fall of the stock market had an overriding role. To start with, the prior stock market boom was instrumental in overexpanding consumption through its wealth effects. Secondly, the stock market catastrophe delivered a big shock to confidence, definitely and dramatically starting the depression on its downward course. The crash for the first time revealed to people the inherent instability of the financial conditions which had prevailed for years. As well, the stock market crash caused a wealth destruction many, many times greater than that perpetrated by the bank failures.

Altogether, bank failures imposed losses on bank stockholders, depositors and other creditors totalling $2.5 billion over the period between 1929 and 1933. Over the same four years, the value of all stocks is estimated to have declined by an enormous $85 billion. These stock market losses, by the way, even exceeded the total amount of bank and thrift deposits. In 1929, these amounted to only $50 billion.

In the 1930s, governments and central banks did not have the faintest understanding of the deeper causes of the depression. Today, their understanding is no better. There were multiple causes — internal and external overindebtedness, large international imbalances in trade and capital flows, severe structural dislocations, and a resulting savage credit and profit squeeze. All these maladjustments had one common originating cause: a prolonged credit inflation, both national and international.

The stock market crash came like a bolt from the blue on October 24, 1929. Actually, money market rates had been dropping sharply since August, two months earlier, giving little forewarning of approaching troubles. Industrial production, which had previously only declined slightly, then crashed with the market. Many investors and speculators today take heart from the fact that stocks quickly rebounded after the crash of 1987. They're overlooking the crucial difference between then and today. Before the October 1987 crash, the world money supply was exploding and fuelling a strong world

economic recovery. Now, world money supply growth is at its weakest point ever in the postwar period and the world economy is struggling with recession.

Of course, America and Wall Street are not alone in the present mania. It's going on worldwide. But events in the U.S. are of central importance for three reasons: first, the U.S. markets are among the most overheated; second, they have a pivotal role internationally; third, it's the general great hope that a recovering U.S. will lead the world out of recession.

THE MESSAGE OF GOLD

Increasingly, we are pondering the question of whether or not the stage is being set for something much bigger than just a slowdown in the U.S. economy. Our chief concern is the growing tension between shrinking overall liquidity, as measured by broad money, and the heightened liquidity risks being sown by boundless financial speculation.

Is gold telling us anything in this situation? Strong rises in gold prices have always been associated with upturns in price inflation with one major exception — the Great Depression period of the 1930s. There was a specific reason why the experience of the 1930s doesn't apply today. Gold rose then because all the currency devaluations during that time were expressed in terms of raising the official gold price. In other words, the price of gold was not determined by the market but by government regulation. This currency link to gold no longer exists today. Currencies rise and fall without any official link to gold.

How then does one fit the gold price into the economic and monetary scenario that we anticipate. The consensus sees a strengthening U.S. recovery with interest rates, inflation and the dollar rising over the balance of the year. What we see is stagflation at best, if not an economic slump, which will weaken the dollar.

The most dramatic changes will take place in the financial markets. The present speculative mania in the United states is also highly reminiscent of that in Japan in 1988-89. There, too, everybody thought that the festivities would go on for ever. Financial leveraging in the U.S. is now going to similar extremes on the conviction that present conditions can continue indefinitely. The fact is that there are limits. In order for such speculative bubbles to continue requires ever greater and greater fuel. It's simply not feasible. Even if nothing else were to trigger a decline, simple exhaustion would set in.

It is possible, too, that the Fed might press the panic button on a misinterpretation of the current situation. Fearing a cyclical inflation increase, they might signal a willingness to increase rates. That would undermine a major support of the stock and financial markets. Whatever the case, we think the stock and bond markets will burst sometime this year. What gives us the courage to make such a specific prediction is the extremely weak developments in money and liquidity relative to GDP growth and the inflation in stock and bond prices.

Falling stock and bond prices, one can safely assume, will lead to a slumping economy. That would trigger a dollar decline . . . a dollar crisis. The resulting higher import prices might well stoke U.S. domestic inflation, as "thinner and leaner" U.S. corporations will be keen to follow suit in order to raise profits. Stagflation is nothing new. Commodity prices, however, would fall. In short, we expect to see relatively contained inflation in the economy alongside savage deflation in the asset markets.

So how will all this affect gold? Is it a valid alternative to plunging stock and bond prices? Traditionally, gold has been seen as a safe haven from inflation. Inflation is one form of currency debasement; currency devaluation, generally followed by rising prices, is the other. A more pronounced fall of the dollar, as we expect, especially if it's perceived as a currency crisis and currency debasement, would certainly trigger a rush out of dollars into both gold and other currencies. This can happen even though price inflation remains relatively contained.

What happens in the final analysis will hinge on inflation and currency developments in other parts of the world, especially in those countries with a strong gold-buying tradition such as in Asia. Where we disagree with the gold bulls is on inflation. A dollar crisis would certainly stoke an inflation tendency, but given the weak economy, there's little prospect of escalating inflation. Rather, as already mentioned, we expect to see asset price deflation. That's not conducive to a rising gold price. In the end, gold may get caught in a tug-of-war between the effects of a dollar crisis and asset price deflation.

YEN STRENGTH AND DOLLAR WEAKNESS

Another hot development in the markets is the skyrocketing Japanese yen. Japan's export surplus in the first quarter of 1993 rose to a record-high of $36 billion, or almost $150 billion at an annual pace. As well, there have been large capital inflows into Japan as foreign investors have snapped up Japanese bonds and stocks. Much of it is surely currency speculation.

For quite a while, though, the yen performed disappointingly. The reason that occurred was because Japanese corporations and banks had built up a huge mountain of foreign debts during the heyday of their speculative years — the period between 1985 and 1989. For a while, repaying these debts was an easy way to dispose of the current-account surplus. Doing so suppressed the rise in the yen. It was only a matter of time before the yen had to burst out on the upside.

Another not too well-known fact is that Japan's soaring current-account surplus is mainly the result of shrinking imports, not rising exports. It is a reflection of contracting domestic demand caused by slumping business investment. After years of overinvestment, Japanese corporations also have had to "downsize" and restructure. Even housing investment is very weak.

The yen's rise will certainly do nothing to lower Japan's current account surplus. In the first instance, it will rise instead, due to the cheapening of Japan's huge dollar-denominated oil and commodity imports. What will happen to export prices is still an open question. It could well end up as an inflationary push for the U.S., if U.S. producers raise prices in tandem with Japanese import prices.

Like most other countries, Japan's economy is also much weaker than expected. Domestic demand continues to shrink as declining investment translates into lower income growth and weak consumption. Consensus hopes for a modest recovery in 1994 hinge on fiscal stimulation and the wealth effects of the stock market recovery. However, the latter was manipulated by the government, driving up prices in the face of slumping profits to ridiculous valuation levels. What's happening is that Japan is trying to start a new asset inflation. We are no great believers in such gimmicks.

The rising yen will surely depress business investment and economic growth further. Under these conditions the trade surplus will continue to increase for a while longer, keeping the yen under upward

pressure. In general, we think, Japan's economic, financial and monetary problems are greatly underestimated. Previous huge losses in the stock and real estate markets have mostly been papered over. Money growth remains just as flat as it is in the United States. In any case, the yen can only rise during a dollar crisis.

CURRENCY RISKS AGAIN IGNORED

Our extraordinary pessimism on the U.S. economy and the dollar is exclusively due to our critical assessment of the economic, monetary and financial developments in America itself. It's a home-made crisis. That doesn't preclude us from being downbeat on the trends in Europe. Nonetheless, it's still our opinion that the consensus verdict of international analysts on Germany is far too pessimistic and is ill-founded.

True, the prospect of a German budget deficit (federal and states combined) as big as 6-7% of GDP is horrible. But our question is this: Where is the budget situation any better even without a unification problem? Everywhere, deficits are soaring because of deepening recession. Britain's deficit is projected to mushroom to 8-9% of GDP. In France, it's headed to 6.5% of GDP. A weaker economy will easily boost the U.S. deficit toward 6% of GDP and in Canada (federal and provincial) it is nearing 8%.

As we've often pointed out, measuring budget deficits relative to GDP is misleading. Deficits have to be weighed against the available domestic savings. By that gauge Germany's fiscal situation is still the strongest of all these countries.

When the Danes gave their "yes" to the watered-down Maastricht treaty last month, there was a surge of euphoria for the non-DM currencies in Europe. The obvious assumption was that this new vote of confidence for EMU (European Monetary Unification) would help stabilize the European Monetary System. On that flimsy belief, all fears of currency risk where thrown to the wind. Huge amounts of capital again flowed into the higher-yielding currencies. As such, this action weakened the DM within the European system. But the new jitters of the just-devalued Spanish Peseta quickly punctured these foolish hopes.

Elsewhere other versions of currency madness are in full swing again . . . at least temporarily. Apparently, past lessons have been forgotten. In Canada, for example, more than $18 billion of foreign capital has flowed into its bond market (primarily new government bond issues) in the first three months of this year. We wonder a bit whether a similar overspeculation isn't happening in French bonds.

Maastricht is dead. The real question is what will be left of the European Monetary System. In our opinion, the greatest threat to the European Monetary System as well as the world currency system will be a deeper U.S. recession and the associated turmoil in the financial markets.

CONCLUSIONS

Not since the 1920s has financial speculation been so rampant. America and Wall Street are not alone in this overspeculation. It's going on worldwide. But events in the U.S. are of central importance. It's the general great hope that the recovering U.S. will lead the world out of recession.

But, the overwhelming evidence is that the U.S. recovery has stalled. It was sick and fragile right from the start in any case. An economic setback will expose the vulnerabilities of the financial markets.

In the scenario that we envisage in the U.S., the dollar, stocks, and bonds will fall concurrently, though at different rates. Yes, even bonds will be undermined despite a weakening economy. The perception of a bad economy is bad for all financial assets. Above all, a dollar crisis would finally prick the financial bond bubble which has served to artificially reduce long-term interest rates.

Recent events in the markets — volatile stocks, weak bonds, and a soft dollar — are a foretaste of more to come. As a matter of fact, there's been more bullish talk than action in the markets for some time already. Bullish conviction is definitely fading.

Capital conservation should be the uppermost priority. For American investors, there is little else to do other than to continue seeking safe harbour in riskless short-term money and to diversify into hard currencies. As for gold, its performance will depend on the extent of any crisis.

Investors outside of North America should stick with bonds in the strong-currency countries, namely Germany, the Netherlands, Switzerland, Austria and Belgium.

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Publisher and Editor, *Currencies and Credit Markets*: Dr. Kurt Richebächer
Mendelssohn Strasse 51, D-6000 Frankfurt 1, GERMANY. TELEPHONE: 49-69-746908 FAX: 49-69-752583

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